Appendix A

In The United States District Court For The Northern District Of California

Provident Securities Company, a California Corporation, Plaintiff, vs. Foremost-McKesson, Inc., a Maryland corporation, Defendant.	C-70 460 RHS OPINION

This is an action for declaratory relief brought by Provident Securities Company, a dissolved California corporation, to determine its nonliability to Foremost-McKesson, Inc. for short-swing profits under §16(b) of the Securities Exchange Act of 1934, 15 U.S.C. §78p(b).

Foremost has filed a counterclaim seeking a declaration of such liability. The matter is before the Court on cross motions for summary judgment and partial summary judgment[1] and would appear to be ripe for such disposition since there does not appear to be any dispute as to the facts.

Provident (now dissolved) was a "family" corporation incorporated under the laws of California in 1915 by the four children of W. H. Crocker for the purpose

[1]The Foremost motion would leave for future determination the amount of such liability.

of managing various assets for the benefit of themselves and their heirs. Its shareholders were the descendants of these four children.

In late 1968, it was decided by those interested that different objectives among the heirs and tax considerations dictated that Provident should either be liquidated or sold and the assets or proceeds from the sale distributed pro rata to the shareholders.

One of the corporations interested in acquiring Provident or its assets was Foremost. After investigation of various other proposals, Provident favored a proposal made by Foremost whereby Foremost would purchase most of Provident's assets. Provident would then liquidate and dissolve by distributing to its shareholders its remaining assets and the consideration received from Foremost for its other assets.

Within these broad outlines, there were extensive negotiations between Provident and Foremost regarding the form of the transaction and the nature of the consideration to be paid by the latter.

To facilitate liquidation and dissolution of the company, Provident was primarily interested in selling to Foremost for cash, but Foremost, for reasons of its own, wished to pay the major portion of the purchase price in securities of Foremost, namely, 6 per cent convertible subordinated debentures due June 15, 1994, to be issued expressly for this purpose. In response to this, Provident argued that if Foremost wanted to use debentures to finance the purchase of Provident's assets, it should sell its own debentures and pay Provident in cash, but this was not acceptable to Foremost.

In an attempt to accommodate Foremost, Provident next stated that it would agree to accept convertible debentures instead of cash provided Foremost agreed to use its best efforts to insure that Provident could sell all of the debentures received at a public offering as soon as possible after the closing of the purchase. Again, Foremost was not willing to accept Provident's suggestion and after extensive negotiations, compromise was reached whereby Foremost agreed to affect registration under the Securities Act of 1933 of up to one half of the debentures to be delivered as payment for Provident's assets and to enter into an underwriting agreement as promptly as possible following the closing of the purchase whereby up to one half of the debentures would be publicly sold by an underwriting group.

On September 25, 1969, a Purchase Agreement was executed by Foremost and Provident which provided that Foremost would purchase approximately two-thirds of Provident's assets for a purchase price of $54,000,000 (subject to certain adjustments) consisting of $4,450,000 in cash and $49,750,000 aggregate principal amount of Foremost's 6 per cent convertible subordinated debentures due June 15, 1994, which were issued expressly for the purpose of acquiring Provident's assets.[2]

The agreement further provided that following the closing of the purchase agreement, Provident could distribute to its shareholders, as part of its plan of liquidation and dissolution, the Foremost debentures delivered pursuant to the Purchase Agreement but that these de-

[2]All of the debentures issued were in fact used for that purpose.

bentures would not be marketable without prior written consent of Foremost unless registered under the Securities Act of 1933. Both the debentures and any common stock issued on conversion were to be legended as follows:

> "The transfer of this security is subject to the conditions specified in a Purchase Agreement dated September 25, 1969, between Foremost-McKesson, Inc. and Provident Securities Company and no transfer of this security shall be valid or effective until such conditions have been fulfilled."

The agreement also provided that Foremost would use its best efforts to cause a registration statement covering an aggregate principal amount of debentures up to $25,000,000, i.e. approximately one-half of the total to be issued, to be filed under the Securities Act of 1933 as soon as practicable after the date of the agreement (September 25, 1969) and agreed to enter into an underwriting agreement whereby the debentures so registered would be sold to the public. It was initially contemplated that all of the debentures delivered to Provident by Foremost in payment for Provident's assets would be distributed in kind to Provident's shareholders and that Provident's shareholders would then be named as the selling debenture holders in the above-mentioned underwriting agreement.

The Purchase Agreement was set to close on October 15, 1969, and contained numerous conditions which had to be satisfied before either party would be bound to close, among which was a condition that the holders of at least one-half of the outstanding common stock of Provident approve and adopt a proposal that Provident be wound

up and dissolved and adopt a plan of complete liquidation of Provident and that the holders of at least one-half of the outstanding common stock and the holders of at least two-thirds of the outstanding preferred stock of Provident approve and ratify the execution of the Purchase Agreement.

As early as September 3, 1969, the Board of Directors of Provident resolved to recommend to the shareholders dissolution and winding up of the corporation and adoption of a plan of complete liquidation and distribution of the corporate assets to the shareholders.

Simultaneously with negotiations for this agreement Provident's Board of Directors and shareholders began procedures necessary for winding up and dissolving the corporation.

On September 29, 1969, Provident filed a certificate of election to wind up and dissolve with the California Secretary of State and mailed notice of intention to wind up and dissolve to all of its creditors and shareholders.

On the same date, Foremost filed a Form S-1 registration statement with the Securities and Exchange Commission pursuant to the Securities Act of 1933 covering the $25,000,000 aggregate principal amount of the Foremost debentures pursuant to which the Provident shareholders, as sellers, would offer the $25,000,000 aggregate principal amount of debentures distributed to them as a liquidating distribution by Provident. This S-1 form was amended on October 3, 1969.

Early in October of 1969, Provident realized that there were several difficulties in having the shareholders them-

selves make the public offering of the $25,000,000 aggregate principal amount of Foremost debentures following distribution of the same to them. Certain of the shareholders were minors and one of the shareholders could not be contacted. The problem was discussed with Foremost, and Foremost orally agreed to a change in the Purchase Agreement so that Provident itself, instead of its shareholders, might sell the $25,000,000 principal amount of debentures. This was really no more than a change in form since by the terms of the Purchase Agreement as originally drawn, Foremost was committed to enter into an underwriting agreement authorizing the immediate sale of $25,000,000 principal amount of Foremost debentures. At a meeting of the Provident shareholders on October 13, 1969, Provident obtained the consent of two-thirds of the preferred stockholders and a majority of the common stockholders to this change and on October 15, 1969, Foremost formally consented in writing to the alteration, and it was incorporated in amendment No. 2 to the S-1 registration form filed on October 21, 1969.

At the closing on October 15, 1969, Foremost delivered to Provident a check for $4,250,000 and a debenture in the principal amount of $40,000,000. Pursuant to the agreement, $2,500,000 principal amount of debentures were delivered to Bank of America National Savings and Trust Association as an escrowholder. The remaining $7,250,000 principal amount of debentures due under the agreement were delivered on October 20, 1969.

After receipt of the debenture in the principal amount of $40,000,000, Provident had it split into two parts, one of $15,000,000 and the other of $25,000,000. Upon receipt

of the final $7,250,000 principal amount of debentures on October 20, Provident executed bond powers to effect transfer of the $7,250,000 and the $15,000,000 aggregate principal amount of debentures pro rata to its shareholders pursuant to a liquidating resolution of the Board previously adopted on October 13, 1969. Instructions to make this distribution were mailed to First National City Bank as trustee under the indenture covering the debentures on October 21, 1969, and the actual mailing of the debentures took place on October 24, 1969. After this distribution, there remained in Provident's possession $25,000,000 aggregate principal amount of debentures. On October 21, 1969, the registration statement under the Securities Act of 1933 covering the $25,000,000 aggregate principal amount of debentures became effective and in accordance with the Purchase Agreement of September 25, 1969, an underwriting agreement between Foremost, Provident and Dillon, Read & Co., Inc., as representative of the underwriting group, covering the $25,000,000 of debentures was executed by all parties. This underwriting agreement closed on October 28, 1969. At the closing, the underwriters delivered $25,366,666.66 to Provident through New York clearing house funds, and Provident delivered the debenture in the principal amount of $25,000,000 to the underwriters. Shortly thereafter Provident distributed cash to its shareholders in the amount of $29,623,500 (including the funds received from the underwriters).

Throughout October of 1969, there were other liquidating dividends paid to Provident's shareholders consisting both of cash and of various securities as the process of liquidation and winding up proceeded.

Section 16(b) provides:

> "For the purpose of preventing the unfair use of information which may have been obtained by such beneficial owner, director, or officer by reason of his relationship to the issuer, any profit realized by him from any purchase and sale, or any sale and purchase, of any equity security of such issuer (other than an exempted security) within any period of less than six months, unless such security was acquired in good faith in connection with a debt previously contracted, shall inure to and be recoverable by the issuer, irrespective of any intention on the part of such beneficial owner, director, or officer in entering into such transaction of holding the security purchased or of not repurchasing the security sold for a period exceeding six months. Suit to recover such profit may be instituted at law or in equity in any court of competent jurisdiction by the issuer, or by the owner of any security of the issuer in the name and in behalf of the issuer if the issuer shall fail or refuse to bring such suit within sixty days after request or shall fail diligently to prosecute the same thereafter; but no such suit shall be brought more than two years after the date such profit was realized. This subsection shall not be construed to cover any transaction where such beneficial owner was not such both at the time of the purchase and sale, or the sale and purchase, of the security involved, or any transaction or transactions which the Commission by rules and regulations may exempt as not comprehended within the purpose of this subsection."

Foremost contends for a starkly literal reading of Section 16(b), which would make Provident, by virtue of its short-lived position as holder of the convertible debentures of Foremost, accountable to it as provided in 16(b)

for the relatively small profit resulting from the underwriting described above, without regard to the overall character of the transaction and its ultimate effect. It makes no claim that any of the evils against which 16(b) were directed were present in this, or that Provident derived inside information, profit or advantage from its all-but-momentary status as an "insider" of Foremost.

To require Provident to pay over to Foremost the amount the latter seeks under Section 16(b) would be to confer a complete windfall upon Foremost and would be utterly at war with any concept of equity known to this Court.

Fortunately, the Courts, mindful of Justice Holmes's oft-quoted canon of statutory construction, by which "[a word] is but the skin of a living thought", have not felt required to apply 16(b) in all cases regardless of concomitant equities and circumstances. In the leading case in this Circuit, Judge Browning, speaking for a unanimous Court, enjoins us that in construing Section 16(b):

> "The initial inquiry must therefore be: What is the purpose of section 16(b)—what practices is the statute designed to prevent." *Blau v. Max Factor & Company*, 342 F.2d 304, 307 (9th Cir.), certiorari denied 382 U.S. 892.

Likewise, the Eighth Circuit has said:

> "There is, however, a very different and difficult problem when a transaction falls within the literal boundaries of the Act, by giving a broad interpretation of the definitions of purchase as 'any contract to buy, purchase or otherwise acquire,' and sale as 'any contract to sell or otherwise dispose of,' yet due to the particular factual situation which makes unfair

> speculation impossible it is clearly beyond the Act's preventive purposes. In that situation the question arises, should the Act be literally applied without further inquiry and without regard to the purposes, or should the broad and arbitrary rules be applied only to situations which are capable of the abuse that the statute was designed to prevent? We believe that each case must be examined on its own facts and the Act only applied when these facts disclose the possibility of abuses that the Act were designed to prevent." *Petteys v. Butler,* 367 F.2d 528, 533 (8th Cir.).

It is sometimes said that Section 16(b) sets forth merely a "crude rule of thumb", the inference being drawn that if the facts, without regard to the purposes of the statute, the surrounding circumstances and the equities inherent therein, are such as are described in that section, the courts have no alternative but to impose liability. However, as to this, the Second Circuit has said:

> "The description, 'a crude rule of thumb,' was first employed by Mr. Thomas Corcoran, spokesman for the drafters of the statute, during congressional hearings on the bill which ultimately became section 16(b). Hearings Before Senate Committee on Banking & Currency, 73d Cong., 2d Sess. 6557 (1934). The phrase now serves to describe not only the statute but also one approach to its application. Under the 'objective' or 'rule of thumb' approach, the statute is applied to all transactions which seem to fall within its terms, without regard to whether imposition of liability would further the purposes of the statute. See, e.g., Heli-Coil Corp. v. Webster, 352 F.2d 156 (3d Cir. 1965). We have rejected this interpretation, see Blau v. Lamb, 363 F.2d 507 (2d Cir. 1966), cert. denied 385 U.S. 1002, 87 S.Ct. 707, 17 L.Ed. 2d 542

(1967), in favor of the more 'pragmatic' approach of applying the statute only to those situations subject to speculative manipulation. For a comparative analysis of the two approaches to application of the statute, which concludes that this Circuit's rule is preferable, see Note, Stock Exchanges Pursuant to Corporate Consolidation: A Section 16(b) 'Purchase or Sale'?, 117 U.Pa. L.Rev. 1035 (1969." *Newmark v. RKO General, Inc.*, 425 F.2d 348, 350, n.).

"The threshold issue raised on this appeal is whether the purchase and subsequent exchange of Central shares lent itself to the type of speculative abuse which section 16(b) was designed to prevent. Blau v. Lehman, 286 F.2d 786 (2d Cir. 1960) aff'd, 368 U.S. 403, 82 S.Ct. 451, 7 L.Ed. 2d 403 (1962); Park & Tilford, Inc. v. Schulte, 160 F.2d 984 (2d Cir.) cert. denied, 332 U.S. 761, 68 S.Ct. 64, 92 L.Ed. 347 (1947)" (emphasis added). *Id.*, at p. 353.

Even a cursory view of the facts presented herein are enough to show that to decide for Foremost would require application of an extremely crude rule of a most deformed and misshapen thumb. In all its essential details the form of the transaction was insisted upon if not dictated by Foremost, often contrary to the plans and wishes of Provident. If the matter had been handled as Provident wished, this case could never have arisen. To allow Foremost under these circumstances to recover the small profit of Provident (almost miniscule in terms of the total amounts involved) simply by a mindlessly literal application of Section 16(b) would be to perpetrate rather than correct an inequity. This the Court is unwilling to do.

Summary judgment will accordingly be rendered for Provident.

Appendix B

United States Court Of Appeals
For The Ninth Circuit

Provident Securities Company, a California corporation, Plaintiff-Appellee, vs. Foremost-McKesson, Inc., a Maryland corporation, Defendant-Appellant.	No. 71-2965 OPINION

[September 19, 1974]

Appeal from the United States District Court
for the Northern District of California

Before: ELY, TRASK and WALLACE, Circuit Judges.

WALLACE, Circuit Judge:

Provident Securities Company (Provident) filed this action, seeking a declaration of nonliability for short-swing profits under section 16(b) of the Securities Exchange Act of 1934, 15 U.S.C. §78p(b). Foremost-McKesson, Inc. (Foremost) counterclaimed, seeking a declaration of liability and recovery of the profits. Both parties moved for summary judgment and the district court found in favor of Provident, holding that the Provident-Foremost transaction did not fall within section 16(b) since it did not involve the potential for speculative abuse

of inside information condemned by the Act. *Provident Securities Co. v. Foremost-McKesson, Inc.*, 331 F.Supp. 787 (N.D. Cal. 1971). We affirm, but on other grounds.

Provident (now dissolved) was a holding company owned by the descendants of W. H. Crocker. In the fall of 1968, it tentatively decided to liquidate its assets and hired Dillon, Read & Company to analyze its financial structure and to seek a purchaser which in turn led to Provident negotiating with Foremost. Initially Provident hoped to sell its assets for cash since cash would be easy to distribute to its shareholders. But eventually it compromised and accepted convertible debentures, one half of which would be registered as soon as possible after closing so that the stock could be offered to the public.

On September 25, 1969, pursuant to this compromise, Provident and Foremost executed a purchase agreement which provided that Foremost would purchase approximately two-thirds of Provident's assets for $54,000,000, consisting of $4,250,000 in cash and $49,750,000 in Foremost six percent convertible subordinated debentures. On October 15, 1969, the closing was held under the purchase agreement. At that time Foremost delivered to Provident a check for $4,250,000 and a debenture in the principal amount of $40,000,000. This debenture was subsequently split into two debentures in the principal amounts of $25,000,000 and $15,000,000. At the time of closing and in Provident's behalf, Foremost also delivered to an escrow agent a debenture in the principal amount of $2,500,000. The debentures were immediately convertible into common stock in an amount in excess of 10 percent of Foremost's outstanding shares. At the completion of the sale, Provi-

dent became a beneficial owner of more than 10 percent of a class of Foremost equity securities as provided in section 16(a) of the Act, 15 U.S.C. §78p(a). On October 20, 1969, Foremost delivered to Provident an additional debenture in the principal amount of $7,250,000.

The following day, October 21, 1969, Provident, Foremost and Dillon, Read & Company, as representative of the underwriting group (Underwriters), executed an underwriting agreement providing for the sale by Provident of the debenture in the principal amount of $25,000,000 to Underwriters at a price of $25,366,666.66. On October 24, 1969, Provident distributed debentures to its shareholders in the aggregate principal amount of $22,250,000. At this point Provident ceased to be a 10-percent shareholder of Foremost stock.

On October 28, 1969, the closing under the underwriting agreement was held and Provident transferred the $25,000,000 debenture to Underwriters in exchange for a check in the amount of $25,366,666.66. The following day, after waiting the necessary time for the check to clear, Provident distributed the cash to its shareholders. On August 31, 1970, following the completion of liquidation proceedings, Provident was dissolved and its remaining assets transferred to a liquidating trust.

A. *The Threshold Test—Potential for Speculative Abuse*

Section 16(b) of the Securities Exchange Act was enacted to prevent corporate officers, directors and principal shareholders from profiteering in inside information through short-swing speculation. The section was designed to discourage corporate insiders from reaping profits

from fluctuations in the price of their corporation's stock that were predictable on the basis of inside information.[1]

Consistent with this statutory purpose, the Supreme Court in *Kern County Land Co. v. Occidental Petroleum Corp.*, 411 U.S. 582, 595 (1973), recently adopted a pragmatic approach that subjects short-swing transactions by an insider to section 16(b) scrutiny only if they involve the potential for speculative abuse of inside information. As a prerequisite to the *Kern County* threshold test, however, the Court indicated that there must be an "unorthodox" transaction such as "stock conversions, exchanges pursuant to mergers and other corporate reorganizations, stock reclassification, and dealings in options, rights, and warrants." 411 U.S. at 593 n.24. The Court's examples of "unorthodox" transactions were probably not intended to be all inclusive but suggest that if the transaction is cash-for-stock or essentially cash-for-stock, then the *Kern County* threshold rule should

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[1]The Senate Report on the bill that became the Securities Exchange Act explained the purpose of section 16(b) as follows:

> The bill further aims to protect the interests of the public by preventing directors, officers, and principal stockholders of a corporation, the stock of which is traded in on exchanges, from speculating in the stock on the basis of information not available to others. Any change in the holdings of such insiders must be reported to the Commission, and profits realized from the purchase and sale, or the sale and purchase of an equity security within a period of less than 6 months are recoverable by the corporation. Such a provision will render difficult or impossible the kind of transactions which were frequently described to the committee, where directors and large stockholders participated in pools trading in the stock of their own companies, with the benefit of *advance information* regarding an increase or resumption of dividends in some cases, and the passing of dividends in others.

S. Rep. No. 792, 73rd Cong., 2d Sess. 9 (1934) (emphasis added).

not be applied. In the orthodox case, the transaction must be tested against the literal terms of the section.

The Provident-Foremost transaction was essentially a cash-for-stock transaction. Provident purchased Foremost debentures, convertible immediately into a large block of common stock, in exchange for two-thirds of its assets. There was no substantial period of delay between the initial agreement and the exchange of consideration. The rights and obligations of the parties were fixed when the purchase agreement was executed. The purchase price did not depend on a formula that was tied to the price of the stock on the market, *cf. Booth v. Varian Associates,* 334 F.2d 1 (1st Cir. 1964), *cert. denied,* 379 U.S. 961 (1965), but was fixed at the time of agreement. The transaction was not merely a record-keeping maneuver, *cf. Blau v. Max Factor & Co.,* 342 F.2d 304 (9th Cir.), *cert. denied,* 382 U.S. 892 (1965), but was an actual transfer of stock for assets. Given these facts there is no reason to treat the Provident-Foremost transaction as anything other than an orthodox sale of stock. As Professor Loss writes:

> Conversion and merger-like transactions aside, the voluntary exchange of securities, either for assets or for other securities, at least of a different issuer, is ordinarily as much a "purchase" or "sale" as if the consideration had been cash.

2 L. Loss, Securities Regulation 1072 (2d ed. 1961) (footnote omitted).

Provident argues that the transaction was in reality not a purchase, but rather a sale of assets. It points out that it originally preferred cash, but, at Foremost's insis-

tence, compromised to accept convertible stock. But even though this assertion may be correct, it does not alter the nature of the transaction for section 16(b) purposes. Provident exchanged its assets for Foremost stock. The only distinction between this transaction and the usual cash-for-stock sale is the nature of the consideration. In all other respects the transaction was orthodox. *See Stella v. Graham-Paige Motors Corp.*, 132 F.Supp. 100, 102-03 (S.D.N.Y. 1955), *modified*, 232 F.2d 299 (2d Cir.), *cert. denied*, 352 U.S. 831 (1956). We see no meaningful distinction between consideration in the form of cash and consideration in the form of a corporate asset. Consequently, as was implicit in *Kern County*, the actual-potential-for-abuse threshold test is not relevant to our determination since that potential is presumed if the elements of the section are satisfied.

But even if the Provident-Foremost transaction were unorthodox, it involved the potential for speculative abuse of inside information and, therefore, is subject to section 16(b) scrutiny. Under the *Kern County* rule it is not necessary that the plaintiff prove actual abuse; the transaction must be subjected to scrutiny if there is a potential. 411 U.S. at 595; *see Smolowe v. Delendo Corp.*, 136 F.2d 231 (2d Cir.), *cert. denied*, 320 U.S. 751 (1943); *The Supreme Court, 1972 Term—Liability for Insider Trading Under Section 16(b)*, 87 Harv. L. Rev. 291, 295-96 (1973). In determining whether a transaction has that potential, the *Kern County* Court looked primarily to two factors: (1) Could the defendant reasonably be expected to have had access to inside information? And (2) did he initiate the transaction voluntarily? 411 U.S. at 596-600.

Section 16 requires that we presume that a stockholder who owns 10 percent of his corporation's stock has access to inside information. Apparently, Congress assumed that a 10-percent shareholder would generally have sufficient control of the corporation to have such access.[2] Where, however, the hostility of the management of the corporation to the 10-percent shareholder precludes any real possibility of access to inside information, as in the *Kern County* tender offer situation, the presumption may be rebutted and the court may conclude that he in fact did not have access. 411 U.S. at 598. Provident has not demonstrated that the Foremost management was hostile. To the contrary, the general cooperation involved in the transaction would indicate that Provident conferred intimately with the Foremost management and could well have had access to confidential corporate information.

The second factor the Supreme Court considered in *Kern County* was whether the transaction was voluntary. Implicit in the decision is the limitation that the *Kern County* rule of leniency should not be applied where the defendant could have avoided section 16(b) liability without serious detriment. *See The Supreme Court, 1972 Term—Liability for Insider Trading Under Section 16(b)*, 87 Harv. L. Rev. 291, 300-01 (1973). There is no evidence in this case to suggest that Provident was forced to enter into any of the transactions. There is evidence, however, to show that Provident's management was aware of the section 16(b) problem and entered the transaction in spite of the possibility that it might be held liable for the

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[2]See the testimony quoted in note 5, *infra*.

profits. Provident has not suggested that it would have suffered any detriment had it not completed the transactions when it did. Absent a showing of involuntariness, we would not be justified in applying the *Kern County* rule.

After Provident became the owner of more than 10 percent of Foremost's stock, it might have had access to inside information which it could have abused for its speculative advantage. For example, assume Provident learned that Foremost had decided not to declare a dividend in order to maintain the capital it would need to develop the real estate just acquired from Provident. On the basis of this information, Provident might have reasoned that the market value of Foremost stock would rise in response to the news of the acquisition and then fall in response to the news of the decision not to declare a dividend. Provident might have concluded that it should sell its stock just after the acquisition news, but just before the dividend news, became public. Such trading is exactly the kind of speculative abuse that section 16(b) is designed to discourage. Thus, even if we assume that the Provident-Foremost transaction was unorthodox, we are required to subject it to section 16(b) scrutiny.

B. *Section 16(b) Scrutiny—The Closing Transaction*

Under section 16(b) the issuer of nonexempt securities may recover from a beneficial owner of 10 percent of its outstanding stock any profits realized from the purchase and sale or sale and purchase of the issuer's stock within a period of six months. Foremost argues that the $366,666.66 that Provident received in excess of the principal

amount of the debenture it sold to Underwriters is a short-swing profit to an insider and thus, under section 16(b), it may be recovered by Foremost as the issuer. At the outset we are faced with the question of when, for purposes of section 16(b), Provident's sale of the debenture to Underwriters was completed. If the sale was completed on October 21, the date the underwriting agreement was executed, Provident was a beneficial owner of 10 percent of Foremost's outstanding stock and we must decide if the remaining requirements of section 16(b) have been satisfied. On the other hand, if the sale was not completed until October 28, the date of the closing and a date subsequent to the distribution of debentures to the shareholders, then Provident was not a beneficial owner of 10 percent at the time of sale, and Foremost cannot recover the profit. *Reliance Electric Co. v. Emerson Electric Co.*, 404 U.S. 418 (1972).

Federal law governs the construction of terms used in the Securities Exchange Act. *Tcherepnin v. Knight*, 389 U.S. 332, 337-38 (1967). *Cf. Blau v. Lehman*, 368 U.S. 403 (1962). Thus, the question of when a sale is complete for purposes of section 16(b) must be decided so as to foster the goals of the federal legislation rather than under concepts of when title passes under state law. *Bershad v. McDonough*, 428 F.2d 693, 696-97 (7th Cir. 1970), cert. denied, 400 U.S. 992 (1971); *see SEC v. National Securities, Inc.*, 393 U.S. 453, 467 (1969). In making this determination, the courts have looked to that point at which the insider has relinquished his ability to control the transaction to the extent that he no longer has the potential to use inside information to his own advantage

and to the detriment of the public or outside shareholders. *See, e.g., Booth v. Varian Associates,* 334 F.2d 1 (1st Cir. 1964), *cert. denied,* 379 U.S. 961 (1965). This ability to control is generally relinquished when the insider is irrevocably bound to sell a specific number of shares at a fixed price, even though the formalities necessary for the transfer of title may not have yet occurred. *Kern County Land Co. v. Occidental Petroleum Corp.,* 411 U.S. 582 (1973); *Booth v. Varian Associates,* 334 F.2d 1 (1st Cir. 1964), *cert. denied,* 379 U.S. 961 (1965); *Blau v. Ogsbury,* 210 F.2d 426, 427 (2d Cir. 1954).

On October 21, when Provident executed the underwriting agreement, it was bound and the price was fixed. After that date, Provident no longer had the potential to use inside information to manipulate the terms and conditions of the agreement. As to Provident, the sale was at that date complete, subject only to the usual conditions precedent to closing.

Provident argues that its obligations under the underwriting agreement were conditional until after closing. But Provident's obligations were conditioned only by the requirements that the registration statement become effective on the date of the agreement, that no stop order issue prior to closing and that Foremost furnish Provident with an opinion letter on the legality of the transaction. None of these conditions subjected Provident to any market risks after the date of the agreement. If the value of Foremost stock had declined in response to the public disclosure of adverse inside information, Provident would nevertheless have received the same price for the stock.

One condition in the agreement, however, may have prevented Provident, for a limited period of time, from benefiting from any possible misuse of adverse inside information. Section seven of the agreement gave Underwriters the right to terminate the agreement prior to the time that the registration statement became effective if in its judgment there had occurred "a material unfavorable change in political, financial or economic conditions generally." Presumably, if the price of Foremost stock had fallen substantially in response to unfavorable information that had become public between the time of execution and the time the registration statement became effective, Underwriters could have terminated the agreement. Nevertheless, the condition does not alter the posture of this case since the registration statement, as required by the agreement, became effective on the same date that the agreement was executed.

We hold that for purposes of section 16(b) the sale of stock was completed on October 21, the date that the underwriting agreement was executed, and not on October 28, the date of closing. On the date of sale, therefore, Provident was the beneficial owner of 10 percent of Foremost's stock.

C. *The Initial Transaction*

In order for section 16(b) liability to attach, however, the insider must have owned 10 percent of the issuer's stock both at the time of purchase and of the sale. The relevant part of the statute reads: "This subsection shall not be construed to cover any transaction where such beneficial owner was not such both at the time of the

purchase and sale, or the sale and purchase, of the security involved. . . ." The correct construction of this language has been the basis of a number of law review commentaries,[3] but there have only been three prior cases that have analyzed it.

The first case in which a court analyzed this language was *Stella v. Graham-Paige Motors Corp.*, 104 F.Supp. 957 (S.D.N.Y. 1952), in which Judge Kaufman concluded that the language "at the time of" must be construed to mean "simultaneously with," rather than prior to. Thus, he held that the initial purchase in which a person becomes the owner of 10 percent of the issuer's stock is a section 16(b) transaction and that a sale within six months serves as the closing transaction, subjecting the seller to liability for any profit. Judge Kaufman's primary rationale for this conclusion was that if the language were construed to mean "prior to," the owner of a large block of stock could reduce his holdings to below 10 percent and then repurchase without liability attaching. 104 F.Supp. at 959.

When the case eventually came before the Second Circuit, the court approved Judge Kaufman's construction without analysis. 232 F.2d 299, 300-01 (2d Cir.), *cert. denied*, 352 U.S. 831 (1956). Judge Hincks dissented, arguing that the initial purchase should not be a transaction within the scope of section 16(b). He reasoned that the language is clear, thus making it inappropriate for the court to go beyond the express terms of the statute and to consider

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[3]*See, e.g.*, Munter, *Section 16(b) Of The Securities Exchange Act of 1934: An Alternative To "Burning Down The Barn In Order To Kill The Rats,"* 52 Corn. L. Q. 69 (1966); Comment, *Section 16(b): An Alternative Approach To The Six-Month Limitation Period*, 20 U.C.L.A. L. Rev. 1289 (1973); 57 Colum. L. Rev. 287 (1957); 70 Harv. L. Rev. 1312 (1957); 9 Stan. L. Rev. 582 (1957).

what Congress must have intended. He further reasoned that the Securities Exchange Act is directed at eliminating the profit to be gained by corporate fiduciaries through speculating on the basis of advance information. A 10-percent shareholder, he argued, is presumed to have access to such information because of the control he has over the corporation; but to conclude that a person has access to such information prior to the purchase in which he became a 10-percent shareholder ignores the rationale of the presumption. 232 F.2d at 304-05.

A district court in the Eighth Circuit adopted Judge Hinck's approach without analysis. *Arkansas Louisiana Gas Co. v. W. R. Stephens Investment Co.,* 141 F.Supp. 841, 847 (W.D. Ark. 1956). Fourteen years later the Court of Appeals for the Eighth Circuit, the only other court to discuss the issue, adopted Judge Kaufman's approach. *Emerson Electric Co. v. Reliance Electric Co.,* 434 F.2d 918 (8th Cir. 1970), *aff'd,* 404 U.S. 418 (1972). On the rationale that any other view would weaken the statute, the court held that the purchase by which a person becomes a 10-percent shareholder can be one of a pair of transactions necessary for section 16(b) liability. Although acknowledging that the congressional intent is "not as clear as desirable," the court concluded that such a construction was consistent with Congress' purpose in enacting the section.

When *Emerson Electric* came before the Supreme Court, the Court noted the issue, but declined to resolve it because a cross-petition for certiorari had not been filed. 404 U.S. at 421. The Court did, however, repeatedly emphasize that the owner must hold 10 percent "both at the

time of purchase and sale." 404 U.S. at 419, 423 and 424. Slightly more than a year later the Court again had the issue before it, but again declined to resolve the issue by deciding the case on other grounds. In *Kern County Land Co. v. Occidental Petroleum Corp.*, 411 U.S. 582, 584 (1973) the Court said:

> Unquestionably, one or more statutory purchases occur when one company, seeking to gain control of another, acquires more than 10% of the stock of the latter through a tender offer made to its shareholders. But is it a § 16(b) "sale" when the target of the tender offer defends itself by merging into a third company and the tender offeror then exchanges his stock for the stock of the surviving company and also grants an option to purchase the latter stock that is not exercisable within the statutory six-month period?

The Court held that the transactions involved in the case before it did not have the potential for speculative abuse of inside information and thus were not within the scope of section 16(b). In view of the Court's repeated emphasis of the language "both at the time of sale and purchase" in *Emerson Electric,* it is unclear whether its statement in *Kern County* was intended to resolve the question of whether the initial purchase is a section 16(b) transaction. Since the Court noted that "one or more statutory purchases occur" during a tender offer, it may have intended that the statutory purchases occur after the purchaser has acquired 10 percent.

This conclusion seems to be required by the Court's later statement that a tender offeror's calculations that he may be able to resell the stock at a profit to a partner of a defensive merger

> do not represent the kind of speculative abuse at which the statute is aimed, for they could not have been based on inside information *obtained from substantial stockholdings that did not yet exist.* Accepting both that Occidental [the tender offeror] made this very prediction and that it would recurringly be an accurate forecast in tender-offer situations, we nevertheless fail to perceive how the fruition of such anticipated events would require, or in any way depend upon, the receipt and use of inside information.

411 U.S. at 597 (emphasis added and footnote omitted). Since a person making a decision to purchase enough stock to increase his holdings to 10 percent of a corporation's outstanding shares could not have made that decision "based on inside information obtained from substantial stockholdings," the Court must have intended for section 16(b) to apply only after that person becomes a statutory insider.

This construction of "at the time of" is supported by the legislative history surrounding the enactment of section 16(b). An early draft of the section read:

> (b) It shall be unlawful for any director, officer, or owner of securities, owning as of record and/or beneficially more than 5 per centum of any class of stock of any issuer, any security of which is registered on a national securities exchange—
>
> (1) To purchase any such registered security with the intention or expectation of selling the same security within six months; and any profit made by such person on any transaction in such a registered security extending over a period of less than six months

> shall inure to and be recoverable by the issuer, irrespective of any intention or expectation on his part in entering into such transaction of holding the security purchased for a period exceeding six months.

Hearings on S. Res. 84, S. Res. 56 and S. Res. 97, Before the Senate Com. on Banking & Currency, 73d Cong., 1st Sess., pt. 15, at 6430 (1934) [hereinafter cited as *1934 Hearings*]. As is apparent from this draft, the section was originally designed to deter insiders from purchasing stock without any intention of making a long-term investment, but only with the intention of profiting from upward fluctuations in the market price that were predictable on the basis of inside information. The section was directed against an insider who has no intention of changing his investment relationship to the corporation, but rather has an "intention or expectation" to purchase and sell the stock within six months. After the pair of transactions is completed he intends to own exactly the same interest in the corporation as he owned before he began his speculative venture. *See Blau v. Max Factor & Co.,* 342 F.2d 304, 308-09 (9th Cir.), *cert. denied,* 382 U.S. 892 (1965); Comment, *Section 16(b): An Alternative Approach to the Six-Month Limitation Period,* 20 U.C.L.A. L. Rev. 1289, 1294-95 (1973).

The limitation period was set arbitrarily at six months since the speculative advantage to be gained from inside information is usually short lived; the fluctuations in the market price generally occur for only a short period of time after the inside information becomes known to the public. After a period of six months little speculative advantage remains. See Comment, *The Scope of "Pur-*

chase and Sale" Under Section 16(b) Of The Exchange Act, 59 Yale L. J. 510, 511 (1950).

As originally drafted the section did not cover the situation where an insider, with inside information adverse to the corporation and indicating a decline in the market price, would sell a large block of stock and later repurchase at a greatly reduced price. Thomas Corcoran, one of the drafters of the section and counsel to the Senate committee, testified as follows:

> Senator BULKLEY. Do you provide for the converse of that, where a man might sell for a short term with the intention of repurchasing?
>
> Mr. CORCORAN. No; it should have been provided for. No; I do not think you need to, sir, because the next section prevents selling short.
>
> Senator BULKLEY. It would not be selling short. He might be a large stockholder, and sell his own stock with the intention of repurchasing.
>
> Mr. CORCORAN. The bill does not cover that case. I do not know whether it should or not.
>
> Senator BULKLEY. Is that not just as reprehensible as to take a short turn on the up side?
>
> Mr. CORCORAN. You see, the next provision prevents either short selling, or selling against the box.
>
> Senator BULKLEY. It would not be a short sale.
>
> Mr. CORCORAN. Or selling against the box.
>
> Senator BULKLEY. It would not be against the box. It would be his own stock.
>
> Mr. CORCORAN. You mean a case where he sold the stock, and within 6 months bought it back at a lower price?
>
> Senator BULKLEY. Yes. A man having a large amount of stock might know that his company was going to pass a dividend, and then sell it with the intention of purchasing after the news was out.

> Mr. CORCORAN. Possibly a provision to catch that should go into the statute. That does not happen as often as the other case.

1934 Hearings, supra, at 6557-58.

Apparently in response to Senator Bulkley's suggestion, the language of the section was amended to read:

> [A]ny profit realized by [a statutory insider] from any purchase and sale, or *any sale and purchase,* of any equity security of such issuer . . . within any period of less than six months . . . shall inure to and be recoverable by the issuer . . . . (Emphasis added.)

Although the amended language includes a sale and repurchase by an insider, there is no indication that the amendment was designed to alter the section's goal of deterring insiders from speculating on the basis of inside information obtained because of "substantial stockholdings." Indeed, the amended version articulates this goal even more clearly than the original draft. In addition to the "purchase and sale, or sale and purchase" language, Congress added a preamble enunciating that the section was enacted.

> [f]or the purpose of preventing the unfair use of information which may have been obtained by such beneficial owner, director, or officer by *reason of his relationship* to the issuer . . . .

15 U.S.C. § 78p(b) (emphasis added).

The drafters recognized, however, the difficulty of proving that the insider actually intended a short-swing transaction when he made his original decision. Mr. Corcoran, after reading the draft section to the committee, testified:

> That is to prevent directors receiving the benefits of short-term speculative swings on the securities of their own companies, because of inside information. The profit on such transaction under the bill would go to the corporation. You hold the director, irrespective of any intention or expectation to sell the security within 6 months after, because it will be absolutely impossible to prove the existence of such intention or expectation, and you have to have this crude rule of thumb, because you cannot undertake the burden of having to prove that the director intended, at the time he bought, to get out on a short swing.

1934 Hearings, supra, at 6557. In order to ameliorate this difficulty of proving intention or expectation, the section created a statutory presumption that a person with access to inside information who purchases and sells, or sells and repurchases, within a six-month period does so with the intent to speculate rather than to invest. That the drafters intended for the presumption to be conclusive is clear from the following testimony:

> Senator GORE. You infer the intent from the fact.
>
> Mr. CORCORAN. From the fact.
>
> Senator KEAN. Suppose he got stuck in something else, and he had to sell?
>
> Senator BARKLEY. All he would get would be what he put into it. He would get his original investment.
>
> Mr. CORCORAN. He would get his money out, but the profit goes to the corporation.
>
> Senator KEAN. Suppose he had to sell.
>
> Mr. CORCORAN. Let him get out what he put in, but give the corporation the profit.

1934 Hearings, supra, at 6557.

Since the presumption of intention or expectation is conclusive,[4] it is necessary that it be narrowly construed so as to apply only to the class of persons who can reasonably be expected to have access to inside information. The hearings demonstrate that Congress intended that the class not be defined too broadly. As originally drafted the presumption applied, in addition to corporate officers and directors, to shareholders who owned five percent of a corporation's stock. The Senate Committee was concerned that a person with that percentage of shares may not have access to inside information[5] and increased the ownership to 10 percent.

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[4]The Supreme Court has recently rejected an argument that section 16(b) should be construed as creating a rebuttable presumption. *See* Reliance Electric Co. v. Emerson Electric Co., 404 U.S. 418, 438 (1972) (Douglas, J., dissenting).

[5]Senator Kean expressed his concern as follows:

> Senator KEAN. I think it is all right to apply it to a director or officer, but I think to require the ordinary investor—
>
> Mr. CORCORAN. Five percent is a lot in a modern corporation. Many corporations are controlled by 5 percent or 10 percent.
>
> Senator KEAN. They may own it or they may sell it. This applies to all corporations, and you are getting down to the point where you are interfering with the individual a good deal there. I agree with you with respect to the officers and directors.
>
> Mr. CORCORAN. A stockholder owning 5 percent is as much an insider as an officer or director. Whether he is a titular director or not, he normally is, as a practical matter of fact, a director.
>
> Senator KEAN. He might not be.

Hearings on S. Res. 84, S. Res. 56 and S. Res. 97, Before the Senate Comm. on Banking & Currency, 73rd Cong., 1st Sess., pt. 15, at 6556 (1934) [hereinafter cited as *1934 Hearings*].

Samuel Untermeyer, an attorney from New York on whose expertise the Committee greatly relied, testified of the same concern:

> Mr. PECORA. The theory was that the ownership of 5 percent of the stock would practically constitute him an insider,

As the Committee testimony indicates, the section also creates a presumption that officers, directors and 10-

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and by virtue of that position he could acquire confidential information which he might use for his own enrichment by trading in the open market, against the interests of the general body of the stockholders. That is the main purpose sought to be served.

Mr. UNTERMEYER. I understand the purpose, and I understand the wisdom of it.

Mr. PECORA. You approve of the principle?

Mr. UNTERMEYER. I approve of the principle, but I do not approve of its application to anybody who owns 5 percent, who is not an officer or director, and has no fiduciary relationship.

Mr. PECORA. If you were to raise that limitation to 20 percent of a listed or registered security, you probably would have difficulty in having it apply to any individual, because it is a grave question whether, in any listed security, there is any individual who owns 20 percent or more of the outstanding stock.

Mr. UNTERMEYER. If he owns less, and is not an officer or director—

Senator KEAN. If he is a director or officer, I think it should apply.

Mr. UNTERMEYER. I agree. I think it should apply. But if he is not—if he has no relation whatever to the corporation, except that he is an investor and owns that amount of security, I do not see why these penalties should be applied to him. They are too severe.

. . .

Mr. PECORA. The only point I want to make is that with that evidence in mind, that management control of an active stock could be obtained through control of 10 percent of the outstanding stock—and there was a large amount of stock outstanding—where an individual owned as much as 5 percent or more, he would be in a position, through the ownership of a block of stock of that size, to virtually be an insider, and he could very well dictate, with one or two others, elections to the board of directors.

Mr. UNTERMEYER. So, you will not let anybody acquire over 5 percent.

Mr. PECORA. It is open to anybody to do it, but he cannot use the information to trade for his own account against the public interest.

Mr. UNTERMEYER. But he cannot get any profit out of it. He is foreclosed from making anything out of it, and the result is that he will not buy it.

Mr. PECORA. He can profit from it provided his transactions are more than 6 months apart. It is designed avowedly

percent shareholders fall within the class of persons who may reasonably be expected to have access to inside information (statutory insiders). It does not appear, however, that this presumption (as distinguished from the presumption of intent to speculate) is always conclusive, since the Supreme Court has held that at least in some situation it may be rebutted. *Kern County Land Co. v. Occidental Petroleum Corp.*, 411 U.S. 582 (1973).

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to prevent insiders from utilizing their position to trade for their own account and against the interests of the general body of the stockholders. The only penalty against it, as you have observed, is that he has to disgorge his profits for the benefit of all the stockholders.

Mr. UNTERMEYER. That is a penalty that will prevent him from buying any more stock, and you will hurt the market in the stock. He may have to buy to protect the stock.

Mr. PECORA. If he buys and does not sell again for another 6 months, he does not have to account.

Mr. UNTERMEYER. But he may just buy for the purpose of protecting the stock, and he may want to sell it as soon as he can. He may not be an insider at all. There are many corporations owned or controlled by big banking houses that have not 1 percent of the stock. They know more about it. They have got more information than the follow (sic) who owns 30 percent of the stock. They know all about it because they are running it. To take one extreme case, like the Wiggin case, and predicate legislation of this kind upon it is very dangerous because, as you know, Mr. Pecora, hard cases make bad laws.

. . .

Mr. UNTERMEYER. I must say [the section] is likely to do more harm than good.

THE CHAIRMAN. You think that that 5 percent ought to be made 20?

Mr. UNTERMEYER. I think so—15 or 20; some substantial amount.

Senator KEAN. Mr. Untermeyer, would it not be satisfactory if you made it apply to the officers or directors?

The CHAIRMAN. That is another provision.

Mr. UNTERMEYER. I think that 5-percent provision should apply to the officers and directors, but I do not think it should apply to anybody who wants to accumulate a larger amount than 5 percent of the stock.

Id. at 7741-43.

Nevertheless, the legislative history demonstrates that the class was not intended to include outsiders. As originally drafted subsection (b)(3) of the section provided that profits received by outsiders from short-swing speculation entered on the basis of confidential information received from insiders could be recovered by the issuer.[6] The provision was deleted from the final draft apparently because the burden of proof required to support a recovery was thought to be too difficult.[7] Since the original draft of the section contained a subsection expressly imposing liability on outsiders and a subsection expressly

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[6]At one time prior to passage, subsection (b)(3) provided:

> (b) It shall be unlawful for any director, officer, or owner of securities, owning as of record and/or beneficially more than 5 per centum of any class of stock of any issuer, any security of which is registered on a national securities exchange——
>
> . . .
>
> (3) To disclose, directly or indirectly, any confidential information regarding or affecting any such registered security not necessary or proper to be disclosed as a part of his corporate duties. Any profit made by any person, to whom such unlawful disclosure shall have been made, in respect of any transaction or transactions in such registered security within a period not exceeding six months after such disclosure shall inure to and be recoverable by the issuer unless such person shall have had no reasonable ground to believe that the disclosure was confidential or was made not in the performance of corporate duties.

1934 Hearings, supra, note 5, at 6430.

[7]The following testimony indicates the Committees concern over the difficulties in proving an abuse of inside information:

> Mr. CORCORAN. Subparagraph (3) affects the friends to whom these corporation directors and officers and big stockholders pass on a tip that the stock is going up for a short swing, and through whom they may conceal their own operations, since the friend may be simply acting as an agent through whom the director, officer, or principal stockholder effects the transaction for his own benefits.
>
> . . .
>
> Senator CAREY. That would mean that if an oil company expected to bring in a well, and an officer knew of it and

imposing liability on insiders, the deletion of the subsection imposing liability on outsiders, without material change in the other subsection, indicates that Congress ultimately decided to exclude outsiders from the operation of the statutory presumption. If Congress had intended for outsiders to be covered by the statute, logically it would have either altered the language of the remaining

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imparted that information to a stockholder, it would be contrary to this law.

Mr. CORCORAN. If that were confidential, and if the stockholder to whom the tip was imparted knew it was confidential and should not have been disclosed. . . .

Then, if there were any profit in the 6 months swing in the stock, the company would get the profit.

Senator CAREY. Suppose he did not say it was confidential, but said they had a good well coming in tomorrow, and this fellow went out and bought some stock?

Mr. CORCORAN. The person who is being sued by the company, if he can show that he had no reasonable ground to believe that the disclosure was confidential or was made not in the performance of corporate duties, would not be liable.

Senator BARKLEY. How can the digging of an oil well be confidential? Anybody who passes along would see it.

Mr. CORCORAN. I do not know anything about the oil business.

Senator CAREY. The information is not always given out.

Senator GORE. They can tell whether they are going to produce, or whether it is a dry well.

Senator BARKLEY. They cannot tell until they finish.

Senator CAREY. I do not see how you can determine when the information is confidential and when it is not.

Mr. CORCORAN. That would depend, sir, upon the nature of the business of the company and the nature of the information.

Senator CAREY. Suppose he said, "I have a letter here today from our man out in the field, and I am certain from what he says that we are going to have a good well." The man goes out into the market and buys.

Mr. CORCORAN. Whether that is a revelation of confidential information depends upon all the circumstances surrounding the case.

Senator CAREY. I think you are breeding a lot of lawsuits here.

Senator GORE. If he says, "strictly between us two," that would be confidential.

1934 Hearings, supra, note 5, at 6560-61.

subsection to provide expressly for such coverage or amended the language of the separate subsection to overcome the objections. Thus, we conclude that the class encompassed by subsection (b)(2) (statutory insiders) was not intended to include outsiders. *See* 9 Stan. L. Rev. 582, 588 n.32 (1957).

Since a person who decides to purchase enough stock to increase his holdings to 10 percent of a corporation's outstanding shares is an outsider at the time he makes his investment decision, he does not fall within the class of persons to which the conclusive presumption was intended to apply. He may have made that decision on the basis of inside information, but such inside information could not have been acquired, in the language of the statute, "by reason of his relationship to the issuer," or in the language of the Supreme Court, "from substantial stockholdings that did not yet exist." *Kern County Land Co.*, 411 U.S. at 597. We hold that the initial purchase by which a person increases his holdings to 10 percent of a corporation's outstanding stock is not a section 16(b) transaction and that the conclusive presumption imputing an intent to speculate does not apply to such a person who sells within six months. The statutory language "at the time of," in order to be consistent with the rationale of the statutory presumption, must be construed to mean prior to the time when the decision to purchase is made.

This construction, however, should not be applied to a transaction that is not an initial purchase but in reality is a repurchase or a closing transaction. It would be inconsistent with the rationale of the presumption and with the

legislative history to allow a principal shareholder to sell his holdings below the 10 percent level and then repurchase at a profit within six months.[8] Where a shareholder was within a class of persons who had access to inside information by reason of their relationship to the issuer prior to making his initial decision to speculate, the conclusive presumption should be applied if simultaneously with the conclusion of the closing transaction he is the owner of 10 percent of the issuer's stock. Although this conclusion mandates that the language "at the time of" means *prior to* in the case of an initial transaction and *simultaneously with* in the case of a closing transaction, we do not believe that this "inconsistency" is inconsistent with the rationale of the section. In order for the statutory presumption of intention or expectation to deter speculation rather than to impose an arbitrary hardship on a good faith investor, it must apply only to shareholders who, at the time they make the decision to purchase or to sell, are within the class of persons who can reasonably be expected to have access to inside information by reason of their relationship to the corporation. This conclusion does not provide a consistent construction of the language "at the time of" for both the initial and the closing transactions, but it is consistent with the rationale

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[8]One example of the speculative abuse of inside information that the section was designed to prevent was reported to Congress as follows:

> In another case, the president of a corporation testified that he and his brothers controlled the company with a little over 10 percent of the shares; that shortly before the company passed a dividend, they disposed of their holdings for upward of $16,000,000 and later repurchased them for about $7,000,000, showing a profit of approximately $9,000,000 on the transaction.

S. Rep. No. 792, 73d Cong., 2d Sess. 9 (1934).

of section 16(b)—a consistency that we believe is much more important than the consistency of terms. It is also consistent with the Supreme Court's instruction that

> where alternative constructions of the terms of § 16(b) are possible, those terms are to be given the construction that best serves the congressional purpose of curbing short-swing speculation by corporate insiders.

Reliance Electric Co. v. Emerson Electric Co., 404 U.S. 418, 424 (1972) (footnote omitted). *See Kern County Land Co. v. Occidental Petroleum Co.*, 411 U.S. 582, 595 (1973). *See also* 9 Stan. L. Rev. 582, 588 n.3 (1957).

With this construction, section 16(b) should be relatively easy to apply. Every section 16(b) fact situation involves a pair of transactions—an initial transaction and a closing transaction. If the defendant is a statutory insider prior to making his decision to enter the initial transaction—regardless of whether it is a purchase or a sale—the conclusive presumption imputing to him an intent to speculate on inside information must be applied if simultaneously with the closing transaction—regardless of whether it is a sale or a repurchase—he is the owner of 10 percent of the issuer's stock and if both transactions have occurred within six months.

We concede that this construction of section 16(b) will not prevent all of the abuses of inside information. A person may well have had inside information at the time he makes a purchase that makes him a 10-percent shareholder. But he may also have had inside information at the time he makes a purchase that makes him a 9-percent shareholder. Additionally, a 10-percent shareholder who sells and repurchases *after* six months may have made the

decision to do so on the basis of inside information. But in order for the conclusive presumption to apply to the transactions, the person must have had access to information at the time of the initial transaction and have executed the closing transaction within six months. If liability is imposed without either of these requirements having been satisfied, the rationale of the presumption will be destroyed. Section 16(b) was not intended to prevent all abuses of inside information, but only speculative abuses of inside information by statutory insiders. Persons injured by other abuses must seek a remedy in other securities laws. *Blau v. Max Factor & Co.*, 342 F.2d 304, 307 (9th Cir.), *cert. denied*, 382 U.S. 892 (1965). For example, a person injured in connection with the sale or purchase of securities because of the abuse of material inside information may have a remedy under section 10(b) of the Securities Exchange Act and rule 10b-5. *See Shapiro v. Merrill, Lynch, Pierce, Fenner & Smith, Inc.*, ... F.2d ..... (2d Cir. April 3, 1974); *Mitchell v. Texas Gulf Sulphur Co.*, 446 F.2d 90 (10th Cir.), *cert. denied*, 404 U.S. 1004 (1971); *SEC v. Texas Gulf Sulphur Co.*, 401 F.2d 833, 848 (2d Cir. 1968); *cert. denied*, 394 U.S. 976 (1969); *In re Cady, Roberts & Co.*, 40 S.E.C. 907 (1961). Although an injured person may be required to prove actual abuse in these cases, such cases do not fall within the ambit of those practices that Congress felt were so injurious to the investment community as to require a conclusive presumption once the fact of short-swing trading at a profit is proved.

In this case Provident was not a statutory insider at the time of its initial purchase. The only possible section

16(b) transaction was the sale of the debenture to Underwriters. Foremost has not alleged a closing transaction within six months of this initial transaction. Absent a pair of section 16(b) transactions within the statutory period, no liability can attach.

AFFIRMED.

Appendix C

FEDERAL STATUTES

Securities Exchange Act of 1934, §§ 3a(13), 3a(14) (15 U.S.C. § 78(c)(13), (14); 48 Stat. 882, 884):

> "(a) When used this chapter, unless the context otherwise requires—
>
> • • • • •
>
> (13) The terms 'buy' and 'purchase' each include any contract to buy, purchase, or otherwise acquire.
>
> (14) The terms 'sale' and 'sell' each include any contract to sell or otherwise dispose of."

Securities Exchange Act of 1934, §§ 16(a), 16(b) (15 U.S.C. § 78p(a), (b); 48 Stat. 896):

> "(a) Every person who is directly or indirectly the beneficial owner of more than 10 per centum of any class of any equity security (other than an exempted security) which is registered pursuant to section 78*l* of this title, or who is a director or an officer of the issuer of such security, shall file, at the time of the registration of such security on a national securities exchange or by the effective date of a registration statement filed pursuant to section 78*l*(g) of this title, or within ten days, after he becomes such beneficial owner, director, or officer, a statement with the Commission (and, if such security is registered on a national securities exchange, also with the exchange) of the amount of all equity securities of such issuer of which he is the beneficial owner, and within ten days after the close of each calendar month thereafter if there has been a change in such ownership during such month, shall file with the Commission

(and if such security is registered on a national securities exchange, shall also file with the exchange), a statement indicating his ownership at the close of the calendar month and such changes in his ownership as have occurred during such calendar month.

"(b) For the purpose of preventing the unfair use of information which may have been obtained by such beneficial owner, director, or officer by reason of his relationship to the issuer, any profit realized by him from any purchase and sale, or any sale and purchase, of any equity security of such issuer (other than an exempted security) within any period of less than six months, unless such security was acquired in good faith in connection with a debt previously contracted, shall inure to and be recoverable by the issuer, irrespective of any intention on the part of such beneficial owner, director, or officer in entering into such transaction of holding the security purchased or of not repurchasing the security sold for a period exceeding six months. Suit to recover such profit may be instituted at law or in equity in any court of competent jurisdiction by the issuer, or by the owner of any security of the issuer in the name and in behalf of the issuer if the issuer shall fail or refuse to bring such suit within sixty days after request or shall fail diligently to prosecute the same thereafter; but no such suit shall be brought more than two years after the date such profit was realized. This subsection shall not be construed to cover any transaction where such beneficial owner was not such both at the time of the purchase and sale, or the sale and purchase, of the security involved, or any transaction or transactions which the Commission by rules and regulations may exempt as not comprehended within the purpose of this subsection."

FEDERAL REGULATIONS

17 C.F.R. 240.16a-4, in pertinent part:

"(a) During the period of 12 months following their appointment and qualification, securities held by the following persons shall be exempt from sections 16(a) and 16(b) of the act:

* * * * *

"(3) Receivers, trustees in bankruptcy, assignees for the benefit of creditors, conservators, liquidating agents, and other similar persons duly authorized by law to administer the estate or assets of other persons."

CALIFORNIA CORPORATIONS CODE

§ 4600:

"Any corporation may elect to wind up its affairs and voluntarily dissolve by the vote or written consent of shareholders or members representing 50 percent or more of the voting power."

§ 4605:

"When a voluntary proceeding for winding up has commenced, the corporation shall cease to carry on business except to the extent necessary for the beneficial winding up thereof, and except during such period as the board of directors may deem necessary to preserve the corporation's good will or going-concern value pending a sale of its business or assets, or both, in whole or in part. The directors forthwith shall cause written notice of the commencement of the proceeding for voluntary winding up to be given by mail to all shareholders and to all known creditors and claimants whose addresses appear on the records of the corporation."

§ 5000:

"After determining that all the known debts and liabilities of a corporation in the process of winding up have been paid or adequately provided for, the directors shall distribute all the remaining corporate assets among the shareholders and owners of shares according to their respective rights and preferences. If the winding up is by court proceeding or subject to court supervision, the distribution shall not be made until after the expiration of any period for the presentation of claims which has been prescribed by order of court."